

Hedge Fund Market Commentary – August 2007 (Mid-Month Report)

The uncertain breadth and depth of subprime losses continue to dominate headlines and appear to be the major source of market volatility. Direct subprime lenders were first to fall. Reports of significant losses by investors in CDOs backed by subprime mortgages came next, capped by large hedge fund losses at Bear Stearns. A revolt in the bond market followed, as investors began rejecting bank loans that had been underwritten at terms (yields and covenants) that were very advantageous to LBO borrowers. Many banks have guaranteed the terms to the private equity firms, causing further concern about their financial health. Yield spreads widened sharply for subprime and prime mortgages, bank loans and high yield bonds. Hardest hit, other than those exposed to subprime, were credit-oriented hedge funds. All that happened in July.

The subprime story has continued into August but has taken a new and quite unexpected twist. July's events caused many investors to begin restructuring their portfolios to increase liquidity and lower risk, apparently surfacing another unexpected system weakness – quant funds – which are supposed to reflect the pinnacle of risk control.

What is happening with quantitatively-driven portfolios is not fully known but reports are that losses were widespread through August 9th and ranged from modest levels of 2-3% for unleveraged long-only traditional equity products to more severe 15-20% losses for leveraged long-short equity market neutral hedge funds, also known as statistical arbitrage funds. Losses experienced by hybrid 130-30 products fell somewhere in the middle of that range.

The cause for the losses is apparently a significant selling by some quant portfolios to raise liquidity or to reduce risk by reducing leverage. This selling puts downward price pressure on long positions and upward price pressure on short positions, creating negative excess return or alpha, at least temporarily. What is surprising and troublesome is that so many quant funds are affected by the actions of a few. Whether by design or not, the strategies of many quant funds now appear to be highly correlated with each other. The notion that each quant fund is a collection of quiet geniuses developing groundbreaking strategies is in danger of vanishing and being replaced by the fear that quant strategies are really fairly simple and vulnerable to imitation. If nothing else good comes of this recent volatility, it could expose the followers and reward the innovators among quant fund managers.

Associated with the recent turmoil has been a dramatic near-term shift in the market away from small-cap value stocks and toward high-cap growth stocks. Quantitative equity market neutral strategies use various measures of value to identify stock alpha but positive alpha tends to be associated with smaller value stocks – low price-to-book, low price-earnings – as opposed to larger growth stocks. The general principal guiding the management of such funds is that there are exploitable deviations, if short-lived, between the fundamental value of stocks and their market prices. These funds thus seek to buy stocks which are priced low relative to their intrinsic value (e.g., small-cap value stocks) and short stocks which are priced high relative to their intrinsic value (e.g., large-cap growth stocks). These discrepancies can not be measured with anything near certainty for most individual stocks. However, over a broad universe of stocks, the noise of stock-specific risk diminishes, and the signal of market mispricing stands out. Quant funds thus buy and short hundreds if not thousands of stocks to profit off of these signals. While they have negligible exposure to market risk, they are very exposed to the risk of reversal in the broad investment themes

represented by the signals, especially given the natural leverage that arises from running a market-neutral strategy (i.e., shorting is a form of borrowing). This is what has been happening in August.¹

To illustrate this, we created a simplistic approximation of a quant fund, a dollar-neutral strategy which buys the Russell 2000 Value index and shorts the Russell 1000 Growth Index.² As shown in Exhibit 1, this strategy would have been very profitable over the last 5 years, but starting in July, would have suffered a dramatic loss.³ However, the reversal is already starting to diminish as investors are taking advantage of a likely profitable opportunity.⁴ Today's announcement that large institutional investors are now opportunistically putting assets into quant strategies will likely further correct the slide in small value stocks.

Exhibit 1: A Simple Market Neutral Strategy

Russell 2000 Value minus Russell 1000 Growth
10/29/2002 through 8/10/2007



While the subprime crisis is real, causing permanent losses from borrower delinquencies and defaults, the contagion brought to the debt and now the equity markets looks to be self-correcting, at least partially. We already see this in the debt markets. Exhibits 2 and 3, which we first presented in our July commentary, show that bank loan and high yield spreads that widened sharply in July are narrowing in August. Perhaps that will also happen to the value-growth dislocation that

¹ Many fundamental equity funds also tend to have small-cap value biases, and thus many also experienced losses in July. However, their losses tended to be lower than those of quant funds since the latter were more exposed to the spread between small value and large growth, resulting in higher sensitivity to the particular events of late July and early August.

² Russell uses both price-to-book and analyst earnings growth forecast to define growth and value. For a complete description of their methodology, see Section 6 of the following document: <http://www.russell.com/indexes/PDF/Methodology.pdf>

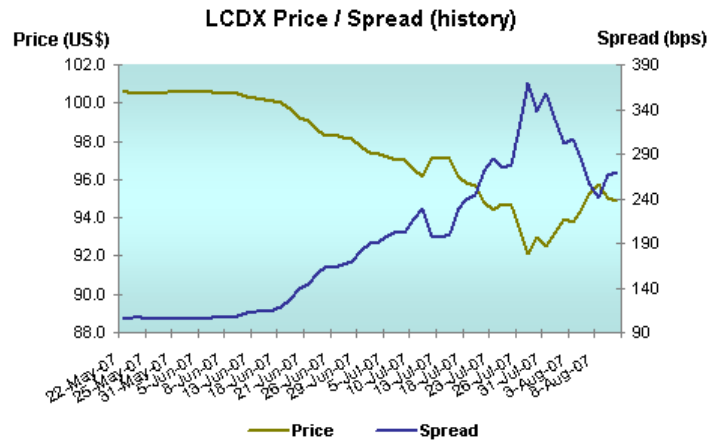
³ On a 20-day rolling basis, the recent reversal represents a four standard deviation event as of market close on August 6th.

⁴ The peak of the turmoil among quant fund managers reportedly occurred a day after the dispersion between small-cap value and large-cap growth began to narrow, suggesting a story more complicated than our simplistic model can account for.

we have been seeing in the equity markets. However, more lasting has to be a concern that the growth of quant strategies, whether they are enhanced index funds, tilts, 130-30, or hedge funds, is causing a false sense of diversification. That may be the real story.

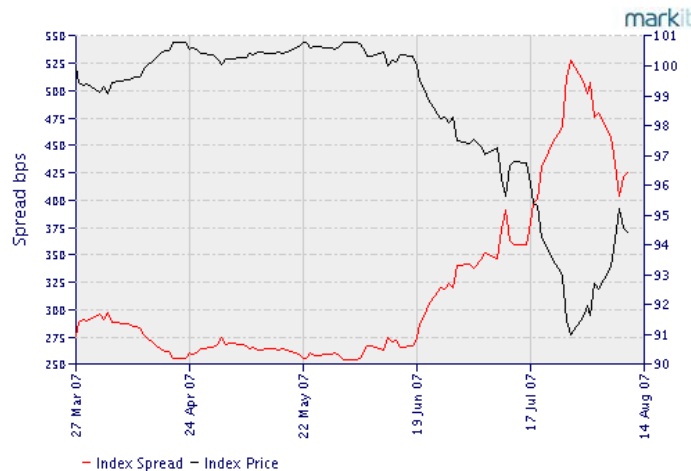
Eli Sokolov
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Exhibit 2: Price and Spread Change on an Index of Bank Loans



Source: Markit. The LCDX is a measure of 100 equally weighted bank loan credit default swaps.

Exhibit 3: Price and Spread Change on an Index of High Yield Bonds



Source: Markit. The CDX is a measure of 100 equally weighted high yield bond credit default swaps.